First Quarter 2005 Commentary

With the party hats and champagne glasses from fourth quarter 2004 now a distant memory, so too is the strong performance the financial markets showed at the end of last year. We now must deal with the real issues of high energy and commodity costs and their inflationary trickle-down effect upon our economy.

The ***Dow and S&P 500 dropped more than 2% for the quarter, while the tech heavy Nasdaq fell over 8%***. Additionally, it is worth noting that the S&P 500 would have actually lost more than 6% for the quarter if the energy and materials sectors were excluded. This is true despite the fact that these two sectors comprise only 10% of the total index.

The run-up in the price of oil has been substantial—so much so that ***there has become a major discontinuity between the physical and financial markets for oil***. With the price per barrel in the mid $50's, we are quite possibly in one of the biggest bubbles in the past 25 years. Even the CEO of Exxon has commented on this stating that ***oil is no longer trading based upon supply and demand economic fundamentals***. Instead, the price is being driven by traders, who by their speculative behavior are making the matter worse each day. Exxon's top man says the fundamentals indicate ***a fair price for oil is probably in the mid to upper $30's***. Despite the increase in price, on an inflation adjusted basis, oil is still well below its price during the 1970's and 1980's.

In the meantime, we are stuck waiting for the price of oil and commodities, and their inflationary effects, to come out of the stratosphere. That has caused the Federal Reserve to proceed in its move to raise short term interest rates. As such, ***the Fed raised the Fed Funds rate ¼ % to 2.75%. This is the seventh rate increase since June of 2004***. While this move itself was no surprise, certain Fed comments may be foreshadowing larger, more aggressive, moves in the future. Many are beginning to speculate that the next rate increase may be ½% versus the past ¼ point moves. With oil prices at a 22 year high and the broad commodity index at a 24 year high it shouldn't take a rocket scientist to see inflationary pressures. Knowing this, we are slightly revising our outlook for the Fed Funds rate from 3.5% by year end to 4.0% within the next 12 months as Greenspan works to keep inflation in check.

The increase in short term rates has finally had an effect upon longer term bond rates. The ***10 year US Treasury Bond increased in yield from 4.0% to more than 4.6%*** making these bonds much more attractive relative to other investments than just a few months ago.

Inflation is rearing its ugly head in other areas also. Medical care costs are up 4.3% from a year ago and education and housing expenses are up also.

Nationally, the median price for existing housing hit $191,000 in February (an 11% increase from one year earlier). While we do not think that there is a nationwide real estate bubble, we do think there are some pockets that are truly overpriced. Additionally, we are concerned with statistics that we feel overstate a persons net worth relative to their debt situation. We have discussed in past commentaries about the over-use (and abuse) of debt and that many Americans are using their homes as fancy ATM machines. Many in the financial media have argued that while debt levels may be high, net worths are also at all time high levels.

What is not being said is that the total of household liabilities, relative to the market value of their total asset holdings, also hit a record high of 18.1% in 2004. As such, ***households are more leveraged now than anytime since 1952*** (when this data first was tracked). Household debt is growing faster than the value of household assets. Additionally, ***the majority of the increase in net worth is coming from housing prices***. This is a precarious situation at best especially if home values falter while debt levels are at ridiculous levels. This situation is a house of cards for many people.

In discussing these issues it is worth reviewing how one increases their net worth. Net worth can increase by spending less than we make (net savings) and then there is the new-era way, called inflated asset price gains. Sadly, today's favorite concept of savings is pouring money into household "investments" such as SUV's and mega-mansions. Further exemplifying this matter is the fact that ***in 2004 household net investment accounted for a meager 8.6% of households increase in net worth—the balance came from increases in housing prices***.

The trickle-down effect of high oil prices is starting to be felt in everything from diapers to Barbie dolls and fertilizer. While these rising prices are contributing to slower growth and higher inflation in the US, they haven't derailed the global economy, which remains robust and able to absorb some of the jolt.

However, as the price of oil and commodities are absorbed they result in a couple of issues. The first is that producers pass on the higher cost of materials and manufacturing to end consumers. While this maintains profit levels at companies (that can pass the expense along), it leaves consumers with less cash for other items. Alternatively, many companies are absorbing the increased cost of goods internally. While this affects consumers less it provides companies with lower profit margins and less opportunity for expansion, improvement in wages or improvement in benefits.

Also, it is worth noting that after a decade of acceleration, ***productivity growth slowed sharply in late 2004***. Productivity is output per worker and determines how costly it is for companies to boost sales.

The US continues to battle a weak dollar relative to other world currencies. While that should make our goods attractive for export, it makes imports even more expensive. With the weak dollar making US exported goods more attractive ***we expect the trade deficit to narrow slightly this year*** to about 5.1% of Gross Domestic Product (from a record 5.3% earlier). The weak dollar alone will not get us out of our trade deficit debacle. Americans, with the lowest savings ratio among industrialized nations, need to save more. At the same time, we need the tight fisted Asian and Europeans to break loose with some of their savings and increase their consumption of US made goods and services.

Given this situation, ***we encourage a conservative, but safe, strategy of saving more and spending less***.

Also, now is a good time to ***review your insurance and risk management needs*** with the attached worksheet.

Finally, we had such a great time at our 5 year anniversary party last year that we have decided to make it an annual event. Therefore, **please put April 28th on your calendar and plan on joining us for food and drinks at Fossati's**.

Please call or stop by with questions.

Sincerely,

Dave Sather

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™

Annual Insurance & Risk Management Review Checklist

Below you will find a number of questions. Please take the time to review these questions and address any questions that you answer “yes” to. Consider changes in these items in the past year or two.

Property

__Bought or sold a house, vacation property, farm, ranch etc.
__Added onto our house or added a pool, barn, workshop or other outbuilding
__Substantially added or decreased a mortgage
__Bought or sold a vehicle
__Added or dropped any new drivers on your policy (especially children)
__Added or sold any other property worth $25,000 (guns, antiques, collectibles, coins etc.) or more?
__Added or subtracted $1 million or more in Personal Liability Umbrella insurance
__My net worth is over $500,000, but I do not have a Personal Liability Umbrella
__My deductibles may be too low causing my premiums to be too high.
__My personal property is not covered for “replacement cost”
__I need smoke detectors in all rooms in my house (garage included)?
__I need carbon monoxide detectors in areas of my house serviced by natural gas?
__I need ABC rated fire extinguishers in my house and garage?

Life Insurance

__ I have added or dropped more than $50,000 of life insurance (don’t forget to consider employer provided insurance).
__ I have changed (or would like to change) a beneficiary designation on an existing policy.
__ I feel I may need more life insurance, but I don't know how much to purchase or what type to consider.
__My family would be substantially burdened economically by my death.
__I have incurred, or may incur, substantial debt and may need life insurance to collateralize those obligations.
__I have changed, or want to change, the beneficiaries on my life insurance.
__I want to gift life insurance out of my estate.

Health Insurance

__I, or my spouse, have changed my insurance provider
__I, or my spouse, have changed jobs
__I used to be covered by a group plan but now am covered by an individual plan
__I have questions about health, disability or long term care insurance deductibles and coverage
__I have changed, or want to change, my disability insurance
__I have changed, or want to change, my long term care insurance
__There are special health concerns that my insurance is not meeting

Changes in Valuation

__ The value of my estate has changed more than 20 percent in the last two years.

Special Provisions for Children

__ My health (my spouse's or children's health) has deteriorated substantially in the last year.

Newly Born or Adopted Children

__ A child (grandchild) has been born (or adopted) since our last review.

Handicapped or Incompetent Children

__ A child (grandchild or other dependent) has become handicapped or seriously injured since our last review.

Status of Family Marriages

__ A member of the family has become married, divorced or separated since our last review.

Business Interests

__ I have entered into a stock (partnership) buy-sell agreement since our last review.
__ My business situation has changed significantly since our last review.
__I have started, sold or terminated a business.